



**FIRST STATE INDEPENDENCE FUND I, LLC**

Financial Statements

December 31, 2008

(With Independent Auditors' Report Thereon)

# FIRST STATE INDEPENDENCE FUND I, LLC

## Table of Contents

	<b>Page</b>
Independent Auditors' Report	1
Management's Discussion and Analysis	3
Basic Financial Statements:	
Statement of Fund Net Assets	5
Statement of Changes in Fund Net Assets	6
Notes to Financial Statements	7
Supplemental Schedule:	
Schedule of Investments	11
Independent Auditors' Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with <i>Government Auditing Standards</i>	12



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## **Independent Auditors' Report**

Members of the Board of Pension Trustees  
First State Independence Fund I, LLC:

We have audited the accompanying statement of fund net assets of the First State Independence Fund I, LLC (the Fund) as of December 31, 2008 and the related statement of changes in fund net assets for the period July 1, 2008 (date of inception) through December 31, 2008. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate under the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the fund net assets of the First State Independence Fund I, LLC as of December 31, 2008 and its changes in fund net assets for the period July 1, 2008 (date of inception) through December 31, 2008, in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 16, 2009 on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The information included in Management's Discussion and Analysis is not a required part of the basic financial statements, but is supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.



Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information included in the Schedule of Investments is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

KPMG LLP

October 16, 2009

# FIRST STATE INDEPENDENCE FUND I, LLC

## Management's Discussion and Analysis

December 31, 2008

(Unaudited)

### Introduction

This section of the financial statements of the First State Independence Fund I, LLC (the Fund) presents our discussion and analysis of the Fund's financial performance during the period ended December 31, 2008. As this discussion and analysis is designed to focus on current activities, it should be read in conjunction with the Fund's basic financial statements, which follow this section.

The Fund commenced operations on July 1, 2008, and as such comparative information with prior year data is not available. In future years, when prior period information is available, a comparative analysis will be presented.

### Financial Statements

The Fund's basic financial statements include the statement of net assets and statement of changes in net assets, which have been presented in accordance with U.S. generally accepted accounting principles as applicable to governmental entities.

The statement of net assets provides information on the financial position of the Fund at period-end. The Statement of changes in net assets presents the results of the investing activities during the period. The notes to the financial statements offer additional discussion that is essential to the full understanding of the data presented in the financial statements. The notes give more detail about accounting policies, significant account balances and activities, material risks, obligations, contingencies and subsequent events, if any. The financial statements and related notes are prepared in accordance with Governmental Accounting Standards Board principles as applicable to governmental entities.

### Statement of Net Assets

The statement of net assets presents the assets, liabilities, and net assets (assets minus liabilities) of the Fund as of the end of the fiscal year and is a point in time financial statement. The statement of net assets comprises the following major components:

Cash and equivalents	\$	27,884
Receivables		355
Investments		140,592
Accrued expenses		<u>(355)</u>
Net assets	\$	<u><u>168,476</u></u>

## FIRST STATE INDEPENDENCE FUND I, LLC

### Management's Discussion and Analysis

December 31, 2008

(Unaudited)

#### Statement of Changes in Net Assets

Changes in net assets from the commencement of operations to period-end are presented in the statement of changes in net assets. The purpose of this statement is to present the net investment income earned by the Fund as well as contributions from members and distributions to members or service providers. A summary follows:

Investment income	\$	(36,178)
Net capital contribution from investor		<u>204,654</u>
Change in net assets	\$	<u><u>168,476</u></u>

The change in net assets during the period of \$168.5 million was primarily attributable to an increase in assets from member contributions of \$204.7 million, and a decrease in assets from unrealized losses of \$34.4 million. The unrealized loss incurred during the period was attributable to declines in domestic and global equity markets across all sectors and styles for the year ended December 31, 2008.

#### Investment Performance

The rate of return (which includes income and changes in the fair value of investments) for the Fund and various market indices are as follows:

	<u>3rd quarter</u>	<u>4th quarter</u>	<u>6 months</u>
Total rate of return	(14.6)%	(8.4)%	(21.8)%
Returns of various market indices (%):			
S & P 500	(8.4)%	(21.9)%	(28.5)%
MSCI world	(15.7)	(22.2)	(34.4)

**FIRST STATE INDEPENDENCE FUND I, LLC**

Statement of Fund Net Assets

December 31, 2008

Assets:	
Cash and cash equivalents	\$ 27,884,115
Receivables:	
Accrued interest income	160
Receivable from DPERS	<u>355,250</u>
Total receivables	<u>355,410</u>
Investments at fair value:	
Alternative investments	140,591,475
Liabilities:	
Accrued investment expenses	<u>(355,250)</u>
Net assets	<u><u>\$ 168,475,750</u></u>

See accompanying notes to financial statements.

**FIRST STATE INDEPENDENCE FUND I, LLC**

Statement of Changes in Fund Net Assets

Period from July 1, 2008 (inception) to December 31, 2008

Investment income	\$ 27,243
Net depreciation in fair value of investments	(35,524,438)
Less investment manager fees	<u>(681,091)</u>
Net investment loss	(36,178,286)
Capital contributions from investor	204,681,091
Distributions to investor	<u>(27,056)</u>
Balance at end of year	<u><u>\$ 168,475,749</u></u>

See accompanying notes to financial statements.

# FIRST STATE INDEPENDENCE FUND I, LLC

## Notes to Financial Statements

December 31, 2008

### (1) Organization

The Board of Pension Trustees (the Board) of the Delaware Public Employees' Retirement System (DPERS or the System) manages the First State Independence Fund I, LLC (the Fund), which was formed on June 25, 2008 and commenced operations on July 1, 2008. The System is the sole member of the Fund. The operations of the Fund are governed by the Board, including the determination of authorized investments for the Fund. Daily operation of the Fund is the responsibility of the State of Delaware Office of Pensions. The Fund is not registered with the Securities and Exchange Commission (SEC) as an investment company.

The Fund was formed for the object and purpose of increasing the investment return on assets of the pension plans of DPERS. The investment objective of the Fund is to realize an annual total investment return exceeding the S&P 500 Index over a full market cycle, net of fees. The investment strategy is to invest in long/short equity hedge funds (underlying funds).

The Fund is a blended component unit of the DPERS and the assets of the Fund are included in the financial statements of the System.

The accompanying financial statements present only the Fund and do not purport to, and do not, present fairly the financial position of the System as of December 31, 2008, and changes in its financial position for the period then ended in conformity with U.S. generally accepted accounting principals.

### (2) Summary of Significant Accounting Policies

#### (a) *Basis of Accounting*

The financial statements are reported using the economic resources measurement focus and the accrual basis of accounting, in conformity with U.S. generally accepted accounting principles. Under this method, revenues (additions) are recorded when earned and expenses (deductions) are recorded at the time liabilities are incurred, regardless of when the related cash flows takes place.

#### (b) *Cash and Cash Equivalents*

Cash and cash equivalents include all cash balances and highly liquid investments with original maturities of less than three months.

#### (c) *Investment Valuation*

Investments in underlying funds are stated at estimated fair value in accordance with procedures established by management, based on information provided by the Investment Advisor, Barlow Partners Inc. and/or valuation information received directly from the underlying fund managers and third-party administrators.

The fair value of the Fund's interest in an underlying fund will represent the amount that the Fund could reasonably expect to receive from an underlying Fund or from a third party if the Fund's interest were redeemed or sold at the time of valuation, based on information reasonably available at the time the valuation is made and that the Fund's management believes to be reliable. These investments are redeemable with the underlying funds at net asset values under the original terms of the partnership agreements and/or subscription agreements and operations of the underlying funds.

# FIRST STATE INDEPENDENCE FUND I, LLC

## Notes to Financial Statements

December 31, 2008

However, it is possible that these redemption rights may be restricted or eliminated by the underlying funds in the future in accordance with the underlying funds agreements. Due to the nature of the investments, their estimated value is subject to uncertainty and therefore may differ significantly from the value that would be used if a ready market for such investments existed. Accordingly, the realized value upon sale of the asset may differ from the fair value. Furthermore, changes to the liquidity provisions of the underlying funds may significantly impact the fair value of the Fund's interests. Under some circumstances, the Fund may determine, based on other information available, that an underlying investment's reported valuation does not represent fair value.

### **(d) *Investment Transactions***

Investment transactions are accounted for on a trade or investment date basis. Gains or losses from investment transactions are determined by the identified cost method. Net appreciation or depreciation in fair value of investments includes net realized losses and the change in net unrealized gains and losses on investments for the fiscal period then ended. The net realized loss from investment transactions amounted to \$1,115,913 and the net decrease in unrealized losses was \$34,408,525, resulting in total net depreciation in fair value of \$35,524,438, for the period ended December 31, 2008.

### **(3) *Related-Party Transactions***

The sole member and manager of the Fund is the System, which resulted in inter-party transfers. \$204,681,091 was transferred in from the System and \$27,055 was transferred back to the System during the period July 1, 2008 (date of inception) to December 31, 2008.

### **(4) *Use of Estimates***

The preparation of financial statements in conformity with U.S. generally accepted accounting principals requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amount of income and expenses during the reporting period. Actual results could differ from those estimates.

### **(5) *Commitments***

The Fund has purchase commitments totaling \$22 million as of December 31, 2008.

### **(6) *Investment Advisory Agreement***

The Adviser, Barlow Partners Inc. (Barlow), is registered with the SEC as an investment adviser under the Investment Advisers Act of 1940, as amended (Advisers Act). The Adviser is responsible for identifying what it considers to be attractive investment opportunities and for analysis of investment performance of the underlying funds. Investment advisory services are provided to the Fund by Barlow pursuant to an investment advisory agreement dated June 25, 2008 (the Advisory Agreement). As compensation for services and facilities provided by the Adviser under the Advisory Agreement, the Fund pays the Adviser each quarter a management fee equal to 0.25% (1.0% annually) of the net asset value of the Fund as of the end of each fiscal quarter. The Fund paid Barlow \$681,091 in management fees for the year ended December 31, 2008.

The Fund indirectly bears fees and expenses as an investor in the underlying funds.

**FIRST STATE INDEPENDENCE FUND I, LLC**

Notes to Financial Statements

December 31, 2008

**(7) Administrative Expense**

DPERS pays for the administrative expenses of the fund (accounting, legal, organizational) from its resources.

**(8) Investments**

The following table lists the Fund's investments in underlying funds (all of which are invested in marketable equity securities) as of December 31, 2008, none of which was a SEC-registered investment.

<b>Investment focus</b>	<b>Market value</b>	<b>Percent allocation</b>
Global Equity	\$ 34,732,850	24.7%
Value	22,568,185	16.0
Global Growth	15,082,491	10.7
Global Financial Services	13,930,071	9.9
Small/Mid Cap Value	11,368,409	8.1
Large Cap Growth	11,034,999	7.8
Global Technology	8,805,481	6.3
Global Natural Resources	5,880,898	4.2
Global Media/Telecom	4,803,275	3.4
Global Healthcare	4,725,973	3.4
Global Energy	3,889,763	2.8
Asian Equity	3,769,080	2.7
	<u>\$ 140,591,475</u>	<u>100.0%</u>

There are no state statutes limiting allowable investments for the Fund. The investment decisions are dictated by the prudent person rule and internal investment guidelines established by the Board, in furtherance of the Fund's investment objectives. For the fiscal year ended December 31, 2008, management of the Fund believes that it has operated in all material respects in accordance with Board guidelines.

Investments are typically subject to various risks. Among these risks are credit risk, concentration of credit risk, custodial credit risk, interest rate risk, and foreign currency risk. Each one of these risks is discussed in more detail below.

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The credit risk of a debt instrument is evaluated by nationally recognized statistical rating agencies such as Moody's Investors Service, Inc., Standard & Poor's, and Fitch Ratings. Concentration of credit risk is the risk of loss attributed to the magnitude of an investment in a single issuer. Interest rate risk is that risk that changes in interest rates will adversely affect the fair value of an investment. Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment.

## **FIRST STATE INDEPENDENCE FUND I, LLC**

### Notes to Financial Statements

December 31, 2008

The Fund's investments in underlying funds are not represented by debt instruments and are not denominated in foreign currencies. As such, none of the above risks apply directly to Fund investments. However, the Fund's investments in underlying funds may contain elements of credit, currency, and market risk. Such risks include, but are not limited to, limited liquidity, absence of regulatory oversight, dependence on key individuals, use of leverage, emphasis on speculative investments, and nondisclosure of portfolio composition. Information about the investments held by the underlying funds is not readily available, so it is unknown whether the Fund holds any single investment whereby the Fund's proportionate share exceeds 5% of the Fund's net assets at December 31, 2008.

**Custodial Credit Risk:** The Fund's \$5,884,115 bank balance represents deposits in short-term investments held by The Northern Trust Co., the custodian bank as of December 31, 2008. Of the Fund's bank balance, \$250,000 is insured by the Federal Deposit Insurance Corporation (FDIC) and \$5,634,115 is uninsured and uncollateralized. The carrying value (book value) of the Fund's deposits reflects the bank balance above in addition to \$22,000,000 which was transferred to the custody of various underlying fund managers pending investment.

#### **(9) Taxes**

The fund is exempt from taxation under Section 115 of the Internal Revenue Code.

**FIRST STATE INDEPENDENCE FUND I, LLC**

## Schedule of Investments

December 31, 2008

<b>Fund</b>	<b>Cost</b>	<b>Unrealized gain (loss)</b>	<b>Market value December 31, 2008</b>
Algebris Global Financials Fund, LP	\$ 10,000,000	(2,293,000)	7,707,000
Ayer Capital Partners Fund, LP	5,000,000	(274,027)	4,725,973
Brookside Capital Partners Fund, LP	16,000,000	(917,509)	15,082,491
CamCap Energy, LP	10,000,000	(6,110,237)	3,889,763
Cantillon World, LP	10,000,000	17,718	10,017,718
Chilton Global Natural	10,000,000	(4,119,102)	5,880,898
Clovis Capital Partners Institutional, LP	14,000,000	(2,631,591)	11,368,409
Coatue Qualified Partners, LP	10,000,000	(1,194,518)	8,805,482
Glenview Institutional Partners, LP	14,000,000	(6,246,047)	7,753,953
Goshen Global Equity, LP	5,000,000	1,223,071	6,223,071
Highside Capital Partners, LP	14,000,000	(2,965,001)	11,034,999
Pennant Onshore Qualified, LP	7,000,000	(737,573)	6,262,427
Penta Japan Domestic Partners II, LP	5,000,000	(1,230,920)	3,769,080
Pershing Square, LP	10,000,000	(1,448,196)	8,551,804
SCP Ocean Fund, LP	14,000,000	(2,005,484)	11,994,516
TCS Capital II, LP	7,000,000	(2,196,725)	4,803,275
Viking Global Equity, LP	14,000,000	(1,279,384)	12,720,616
Total	\$ <u>175,000,000</u>	<u>(34,408,525)</u>	<u>140,591,475</u>

See accompanying independent auditors' report.



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**Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards***

Members of the Board of Pension Trustees  
First State Independence Fund I, LLC:

We have audited the financial statements of the First State Independence Fund I, LLC (the Fund) as of December 31, 2008 and for the period July 1, 2008 (date of inception) through December 31, 2008, and have issued our report thereon dated October 16, 2009. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

**Internal Control over Financial Reporting**

In planning and performing our audit, we considered the Fund's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Fund's internal control over financial reporting.

A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.



We noted certain matters that we reported to management of the Fund in a separate letter dated October 16, 2009.

This report is intended solely for the information and use of management, the Board of Pension Trustees, Secretary of Finance, Office of the Controller General, Office of the Attorney General, Office of the Governor, and the Office of the Management and Budget and is not intended to be and should not be used by anyone other than these specified parties. However, under 29 Del C., Section 10002(d), this report is public and its distribution is not limited.

KPMG LLP

October 16, 2009